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FEDERAL COMMUNICATIONS COMMISSION
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AUG 25 1993
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)
)
Implementation of Sections of)
the Cable Television Consumer)
Protection and Competition Act)
of 1992)
)
Rate Regulation)

MM Docket No. 93-215

COMMENTS OF CABLEVISION SYSTEMS CORPORATION

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Cablevision Systems Corporation ("Cablevision"), by its attorneys, hereby submits its comments in response to the above-captioned Notice of Proposed Rulemaking ("Notice").

INTRODUCTION AND SUMMARY

The financial history of the cable industry reflects the ongoing effort to balance two competing economic demands. On one hand, there is the need to attract substantial investment capital to an inherently risky business venture; on the other, the recognition that subscriber rates must be set at levels designed to attract and retain customers for what they regard as a non-essential service. The constraint on rates has meant that cable investors must defer a return on their investment for many years while systems grow. This pattern continues to the present day: operators now face market- and government-driven demands for substantial new investments in an advanced telecommunications infrastructure (requiring new infusions of capital that must be paid for) at the same time as they seek to increase subscriber

penetration, which remains at less than two-thirds of all television households passed by cable.

A set of investor expectations, financial and accounting practices, debtor-creditor arrangements, and investment and acquisition patterns has grown up around the cable industry in an effort to accommodate the sometimes contradictory goals of attracting both capital and subscribers. The sum of these factors -- the nationwide deployment of a broadband telecommunications infrastructure in less than thirty years -- has produced immense subscriber and public benefits, and the industry is now poised to rebuild that infrastructure to offer an even wider array of services. Cost-of-service standards that do not take full account of the economics and the financial requirements of the cable industry could bring that effort to a halt by drying up sources of capital.

Congress recognized that traditional utility regulation was inappropriate for the cable industry. Likewise, there are significant constitutional limitations on the ability of an agency to disrupt settled, reasonable investor expectations in a manner that deprives an industry of the funding it needs to survive and grow. Consistent with these statutory and constitutional directives, the cost-of-service standards must balance "the investor and the consumer interests."^{1/} Failure to do so will substantially diminish the ability and incentives of

^{1/} Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944) ("Hope").

cable operators to make the significant investments in new technology and programming necessary to respond to subscriber demand.

The Commission should abandon its proposal to exclude from the ratebase all excess acquisition costs. Adoption of this proposal would gravely disrupt the capital and financial structure of the cable industry, defeat the purpose of the cost of service proceeding, thwart Congressional intent, and run afoul of the Constitution. Acquisition premiums constitute a substantial portion of the cable industry's invested capital, and were incurred as a result of arms-length transactions in a deregulatory environment specifically sanctioned by Congress. The Commission should simply premise the validity of all acquisition costs incurred prior to enactment of the 1992 Cable Act. At a minimum, the Commission, must allow operators an opportunity to demonstrate the legitimacy of acquisition premiums.

While traditional utility regulators seeks to achieve a precise fit between rates and costs, the goal of cost of service regulation for cable is simply to determine whether an operator has valid reasons for charging rates which exceed the benchmarks. Therefore, the Commission should adopt a pragmatic, rather than formulaic, approach to valuating a cable system's plant in service.

The Commission also should allow cable operators to include within the ratebase the unrecovered portion of accumulated net

operating losses. In order to ensure continued access to capital and adequately compensate cable investors for the unique set of risks which they face, the Commission must adopt a higher rate of return than that which was proposed in the Notice. Finally, there are a number of issues, such as depreciation, accounting and cost allocation standards, and the selection of test year methodology, which the Commission should address on a case-by-case basis or by convening industry groups rather than through the adoption of generic requirements.

I. TO ENSURE CONTINUED INVESTMENT IN CABLE, AND CONSISTENT WITH STATUTORY AND CONSTITUTIONAL DIRECTIVES, THE COMMISSION'S COST-OF-SERVICE RULES MUST BE TAILORED TO MEET THE ECONOMICS AND THE FINANCIAL REQUIREMENTS OF THE CABLE INDUSTRY

In order to ensure the continued growth of the cable industry, the cost-of-service rules must be tailored to meet the cable industry's economics and financial requirements.

Regulations that are mere carbon copies of schemes developed for other industries, by preventing operators from setting rates based on the unique costs of building and operating the cable infrastructure, will defeat investors' reasonable expectations of a return on past investments and deprive operators of the ability to attract new capital. Such a result would be inconsistent with the legislative admonition against "replicating" utility regulations, and raises serious constitutional concerns.

Appropriate cost-of-service regulations are a necessary complement to the Commission's benchmark rate regulation scheme, which have already begun eroding the cable industry's financial

climate. In the months since reregulation, the capital markets have become increasingly wary about making additional investments in cable.^{2/} For instance, Moody's Investor Service has placed Cablevision on a "watch list," warning that Cablevision's bonds may be downgraded.^{3/}

For Cablevision, the Commission's benchmark approach to rate regulation could also mean a reduction of ten percent of Cablevision's cash flow,^{4/} threatening to render the company "unable to comply with certain of the financial covenants contained in the Credit Agreement during fiscal year 1994."^{5/} Like nearly all cable industry financing, Cablevision's loan covenants require the company to maintain certain minimal levels of cash flow ratios.^{6/} In some instances, Cablevision will be unable to comply with its covenants if the cost-of-service regulations fail to properly reflect its economics and its financial characteristics, as well as its capital structure. Similarly, other debt costs incurred by the company are

^{2/} See e.g., "Ratings Groups Worry About MSOs Debt," Multichannel News, July 26, 1993, at 44; "Report: Rereg Will Hamstring Cable's Efforts to Deleverage," CableWorld, August 9, 1993, at 45; cf. Exhibit 1 (letters to Commission from lending institutions regarding impact of rate regulation rules on cable television financing).

^{3/} "Ratings Groups Worry About MSOs Debt," Multichannel News, July 26, 1993, at 44.

^{4/} See Exhibit 2 (excerpt from Cablevision Form 10-Q (filed August, 1993)) at 20.

^{5/} See id. at 24.

^{6/} See Exhibit 3 (summarizing key financial covenants of existing debt).

adjustable depending upon the ratio of debt to cash flow. If the Commission's rules reduce cash flow substantially, the company's debt service expenses and capital costs will increase, which will shrink the pool of funds available for new investment.

The cost-of-service rules must function as the "backstop" for benchmark rate regulation, to ensure the systems whose benchmark rates do not enable them to satisfy subscriber and investor expectations have an alternative means of justifying a rate that is adequate to attract the new capital necessary to implement technological changes in an environment characterized both by substantial regulation and growing competition.^{7/}

A. RECOVERY OF THE INVESTMENT IN CABLE OPERATIONS IS DEFERRED OVER AN UNUSUALLY LONG TIME PERIOD AND CABLE INVESTORS FACE MARKET RISKS THAT TRADITIONAL UTILITY INVESTORS DO NOT ENCOUNTER

Cablevision's history illustrates the unique financial circumstances and economics of the cable industry. Cablevision began operations in 1973 with a single system on Long Island. Currently, Cablevision and its affiliated systems serve over 2 million subscribers in 19 states. Over the past five years, the company has acquired approximately 75 systems, and has invested more than \$431 million in infrastructure investments. Just recently, Cablevision announced plans to build a \$800 million fiber optic superhighway on Long Island, and has completed the first phase of construction.

^{7/} Many Cablevision franchises presently require the Company to provide "state-of-the-art" systems. When franchises must be renewed, it is unlikely that franchising authorities will be satisfied with technological dinosaurs.

Cablevision's initial operations incurred substantial start-up losses (represented by large accumulated deficits) because of the considerable up-front investment in plant and equipment needed to initiate service to subscribers. Rates were set at levels designed to encourage consumers to subscribe to cable services and eventually to reduce costs per subscriber. The company recognized that the fixed investment would only be recoverable over time, as the subscriber base increased. Thus, investment and pricing decisions were aimed at attaining the goal of increasing subscriber penetration. The company consequently accumulated large losses, which continue to be reflected in the company's balance sheets.^{8/}

While Congress' decision in 1984 to deregulate the cable industry facilitated Cablevision's access to capital, it also reinforced the practice of postponing capital recovery. Deregulation further encouraged the company to make long-term investment and pricing decisions aimed at increasing penetration, while deferring cost recovery and capital return until systems reached maturation. Rate-setting decisions have been, and continue to be, motivated less by cost recovery concerns and more by a desire to establish satisfactory levels of cash flow to cover debt service, fund new investment, and increase penetration. While rate increases have occurred during this

^{8/} See Exhibit 4 (excerpts from Cablevision Systems Corporation Form 10-K 1992 Annual Report) at 46-81; cf. Exhibit 5 (chart depicting net operating loss of an actual Cablevision system).

period -- in part because of increases in programming and general overhead costs^{9/} -- many of Cablevision's systems do not fully recover costs and continue to operate at a loss. For instance, the Cablevision system represented in the graph attached as Exhibit 5 continues to generate significant losses from operations. This is not an acquired system, so the accumulated losses cannot be said to represent "excess" acquisition costs. Rather, these losses generally stem from the lack of coverage of depreciation and interest payments (investor funds). Essentially the investors are willing to forego recovery of the depreciation (return of their investment) and the interest costs (return on their investment) currently and postpone the recovery until the system matures.

There is widespread consensus that the pattern of the investment in the cable industry during the period of deregulation yielded significant benefits for subscribers.^{10/} Penetration levels jumped as a result of increased channel capacity, new programming services were offered, and the technical sophistication and reliability of cable networks advanced. During the past five years alone, for instance, the number of homes passed and basic subscribers served by Cablevision cable systems increased by approximately one-

^{9/} See Exhibit 4 at 8, 28.

^{10/} See e.g., H.R. Rep. No. 628, 102d Cong., 2d Sess. 29 (1992) ("House Report").

third.^{11/} During the same period, subscription to "premium" services offered by Cablevision cable systems rose by more than forty-five percent.^{12/} Nonetheless, Cablevision and many other cable operators still have not attained an equitable return on the considerable investment needed to produce those successes.

The Commission itself has acknowledged the prevalence and persistence of accumulated net operating losses in the cable industry.^{13/} Indeed, systems that Cablevision originally built in the late 1970s and early 1980s continue to show operating losses because subscriber penetration has yet to reach optimal levels.^{14/} Because it is unlikely that the benchmark rules will yield revenues sufficient to satisfy investor expectations in a timely manner, the stability of these systems' financial structure hinges upon the adequacy of the cost-of-service rules developed by the Commission.^{15/}

The Commission's cost-of-service rules also need to reflect the fact that cable investors, unlike investors in traditional utilities, face considerable market risks. Cable enjoys less

^{11/} See Exhibit 4 at 29.

^{12/} See id.

^{13/} See Notice at ¶ 39 n.44.

^{14/} See Exhibit 5.

^{15/} While cable investors generally have been willing to defer capital recovery over a longer-than-usual time period, they have sought certain assurances in return for this deferral. A regulatory framework that prevents an operator from satisfying such assurances will diminish access to capital, jeopardize loan agreements, and raise debt service costs -- increasing upward pressure on subscriber rates.

penetration and experiences much greater churn rates than traditional utilities.^{16/} Cable, moreover, not only faces the prospect of vigorous competition from a host of alternative multichannel technologies; it is now required by law to assist in the growth of its competitors.^{17/} The market risks faced by cable investors underscore the importance of developing a backstop mechanism which encourages new investment by assuring adequate returns to capital.

B. CABLEVISION'S SYSTEM ACQUISITIONS HAVE BEEN AN ESSENTIAL COMPONENT OF THE GROWTH IN SERVICES AND TECHNICAL SOPHISTICATION OFFERED TO ITS SUBSCRIBERS

The broad characterization of all or part of cable acquisition adjustments as "excess" is unfair and, if adopted, would deprive the company of a reasonable return on its cable-dedicated investment. Since 1984, Cablevision has acquired 77 new systems -- in approximately 600 franchise areas -- in order to expand its cable business and augment its ability to offer significant new and enhanced services to its subscribers.^{18/} These acquisitions were the result of willing sellers and a willing buyer finding common ground, on an arm's-length basis,

^{16/} For instance, Cablevision experiences churn rates of 4.0 percent and 2.5 percent in systems in Massachusetts and Long Island, respectively. The cable industry's penetration rate is approximately 60 percent. See "Cable Television Developments," National Cable Television Association, March 1993, at 1-A.

^{17/} See 47 U.S.C. § 548. While this increased competition will require operators to continue to invest in their systems, it may also raise their costs of capital, especially when it is coupled with re-regulation.

^{18/} See Exhibit 6 (chart listing Cablevision major acquisitions).

that resulted in benefits to both parties and to subscribers. The bulk of these acquisitions have been aimed at developing strategic geographical clusters which can raise the quality of the overall infrastructure and yield efficiencies that benefit both investors and subscribers. In a number of instances, acquisitions have led to the clustering of small systems which can consolidate delivery facilities and eliminate redundant costs.^{19/} These acquisitions also have reduced per subscriber charges for programming and yielded other cost savings.^{20/}

The network improvements, efficiencies, cost-savings, and other subscriber benefits engendered by these strategic clusters were not given to Cablevision for free by the seller of the acquired systems. The fact that cable system acquisition prices may have exceeded the net book value of the plant in service also may be attributed in large part to the seller's need to recapture start-up losses and realize the deferred returns on his invested capital.^{21/}

^{19/} One recent Cablevision acquisition of approximately 300 franchise areas resulted in external cost savings of over 15 percent and significant cost reductions. These reductions permitted the Company to make capital improvements of over \$18 million per year.

^{20/} For example, consolidation has led to cost savings in the areas of management, data processing, purchasing, and customer service representatives.

^{21/} Moreover, what is shown as "net book value" may not have been computed correctly by the seller. In the past, not all of Cablevision's sellers have used GAAP. For instance, Cablevision has acquired systems where little or no "book value" existed simply because the seller utilized unacceptable accelerated depreciation methods.

As noted above, existing Cablevision systems continue to generate large net operating losses, while the investment in property, plant and equipment has been reduced by accumulated depreciation. If Cablevision sold one of these systems to a third party, it would ask for recovery of the net investment as of the date of the sale plus the deferred return on and of the prior unrecovered investment (net operating losses) that does not directly show on the balance sheet after acquisition. Assuming, for instance, that the system depicted in Exhibit 5 sold for \$1,800 per subscriber, the "book" acquisition adjustment of approximately \$130 million (estimated purchase price less tangible assets net of anticipated acquired liabilities) would be comprised of approximately \$115 million of accumulated net operating losses. These losses should be allowed to be recovered from the subscribers in order to return to these current investors the deferred return on and of their investment.

Cost-of-service rules that deny cable investors the opportunity to earn a return on the full amount of their invested capital, including investments through funding of net operating losses -- by characterizing amounts over original cost as "excess" and excluding them from an operator's ratebase -- unfairly penalizes the investors who funded these arm's-length transactions and does not recognize the accumulated investments of previous owners. On a going-forward basis, such restrictive

rules will disrupt relations with creditors and make it far more difficult for the company to raise new capital.^{22/}

C. CONSISTENT WITH THE LEGISLATIVE INTENT, THE COMMISSION'S COST OF SERVICE MUST BE SPECIFICALLY GEARED TO THE UNIQUE NATURE OF THE CABLE INDUSTRY

Recognizing the "unique nature of the cable industry,"^{23/} Congress was clear that the rate regulatory scheme for cable should not replicate traditional rate of return regulation. Such an approach would impose financial and administrative burdens on the industry and the regulators,^{24/} and was inappropriate for an

^{22/} It is worth noting that many of Cablevision's system acquisitions required approval by local franchising authorities, which reviewed the proposed transactions and assessed their impact on subscribers prior to giving approval. Implicit in these showings is a recovery of the costs of the acquired system plus all acquisition adjustments. See, e.g., Exhibit 7 (excerpts from local application for approval of restructuring plan). There is no basis for the Commission to second-guess the judgment of these franchising authorities about the fairness of these transactions for subscribers. Nor is there any basis for the Commission's implicit assumption that local regulators who had the power to disapprove a transaction would nonetheless allow it to go forward even though it would result in the extraction of future monopoly rents from subscribers.

In other instances, franchising authorities required Cablevision to make the investments on which the Commission's proposed rules would now prevent the company from earning a return. The New York State Cable Television Commission, for example, has conditioned approval of a number of system purchases upon Cablevision's commitment to upgrade its systems to 77 channels. The cost of required upgrades for one Long Island system alone is more than \$102 million.

^{23/} S. Rep. No. 92, 102d Cong., 1st Sess. 18 (1991) ("Senate Report").

^{24/} See, e.g., House Report at 83 ("The Committee intends that the Commission establish a formula that is not cumbersome for the cable operator to implement nor for the relevant authorities to enforce. The Committee is concerned that several of the terms used in this section are similar to those used in

(continued...)

industry with "no history of establishing rates for cable service that is analogous, for example, to the process used in the telephone industry."^{25/} Moreover, price controls are being imposed upon cable well before the industry has achieved full maturity or optimal penetration levels.^{26/} Indeed, cable has just emerged from eight years of rapid expansion in a deregulatory marketplace specifically sanctioned by Congress,^{27/} and will soon face a vigorously competitive marketplace which Congress has sought to hasten through passage of the 1992 Cable

^{24/} (...continued)

the regulation of telephone common carriers. It is not the Committee's intention to replicate Title II regulation. The FCC should create a formula that is uncomplicated to implement, administer and enforce, and should avoid creating a cable equivalent of a common carrier "cost allocation manual.")

^{25/} Senate Report at 73. Congress also has rejected the use of "regulatory or structural approaches that . . . involve changing cable's mode of operation." Id. at 18.

^{26/} For instance, Cablevision is currently building an urban system in New York City. While this system, which has been operating in certain areas of the city for up to four years, has experienced significant growth, its penetration rate remains significantly below an optimal level. In fact, in one of the areas built, penetration is less than ten percent.

^{27/} The 1984 Cable Act, Cable Communications Policy Act of 1984, Pub. L. No. 98-549, 98 Stat. 2779 (1984), prohibited the regulation of subscriber rates except for basic service "in circumstances in which a cable system is not subject to effective competition." 47 U.S.C. § 543(b)(1), repealed by 1992 Cable Act. Under the Commission's definition of "effective competition," systems serving no more than 34 percent of all subscribers were subject to rate regulation prior to enactment of the 1992 Cable Act. See Senate Report at 8.

Act. Under these circumstances, a conventional regulatory model is clearly inappropriate for cable.^{28/}

Imposing utility regulation upon the cable industry -- as the Commission appears to propose in the Notice -- would also frustrate the statutory goal of encouraging continued investment by cable companies in their telecommunications infrastructure and

^{28/} Each of these differences standing alone would be sufficient to distinguish the cable industry from a traditional utility. But the sum of these factors underlines the importance of tailoring the Commission's cost-of-service rules to the cable industry's unique circumstances.

A cable operator faces an entirely different set of circumstances than a traditional utility, because of its penetration levels, the prospect of churn, and the threat of competition. In general, cable operators must postpone full recovery on their capital improvements until much later in the life of the newly constructed plant in order to attract new subscribers and prevent churn. For example, assume that a relatively young cable system which has (as many systems do) less than 50% penetration makes a substantial capital investment in system infrastructure in order to increase existing penetration and serve existing subscribers more effectively. Even if regulators regarded the investment as completely beneficial to subscribers, most operators would not be able to recover the full authorized rate of return on the investment in the early years following approval. The reason is simple: cable operators need to increase penetration and prevent churn, and a first-year rate increase which provides a return on the capital improvement would repel both new and existing subscribers. Full recovery on that investment must be delayed until later in the life of the improvement, when penetration has grown, and the costs can be spread over a broader base of subscribers.

It is critical for the Commission to recognize that under a conventional cost-of-service model, a cable system in the circumstances described above would not be able to recover the full earnings to which it is entitled. Because of both depreciation and the cap on the rate of return, the cost base in the later years would not justify the rates needed to recover the earnings which were deferred in the early years in order to boost subscribership.

new programming services.^{29/} A regulatory scheme that thwarts growth, increases operating losses, stifles infrastructure development, impairs operators' ability to attract capital, and discourages the offering of new services would contravene the intent of the Act. Such a scheme also would implicate constitutional concerns.^{30/} The Commission is under a clear directive to ensure that its regulations enable cable operators to earn a fair return on their investments, so that the full potential of cable technology can be made available to subscribers.

While the Commission's benchmark rules represent one alternative regulatory framework for cable which departs from traditional utility regulation, they do not represent the only alternative. The Commission itself recognized that strict application of the benchmarks on an across-the-board basis might not enable some cable operators "to recover the reasonable costs of providing regulated cable service," contrary to the statutory

^{29/} See Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, § 2(b)(3), 106 Stat. 1460, 1463 (1992) ("1992 Cable Act") (declaring policy of Congress to "ensure that cable operators continue to expand, where economically justified, their capacity and the programs offered over their cable systems"); see also House Report at 29 (noting the "tremendous growth" of the cable industry and the increase in the level and quality of investment in cable television infrastructure and programming in the years immediately preceding passage of the 1992 Cable Act).

^{30/} See Section II.C, infra.

directive to ensure a reasonable return.^{31/} The Commission also has acknowledged that an alternative to the benchmark approach was necessary to ensure the continued investment by cable operators in their telecommunications infrastructure.^{32/} Operators should have an opportunity to demonstrate their costs on a case-by-case basis in a cost-of-service proceeding.

While it is clear that the Commission must develop some kind of cost-of-service rules, it is equally plain that those cost-of-service rules must be consistent with Congress' requirement that cable not be subject to traditional utility rate regulation. The availability of the benchmark formula does not provide the Commission with an excuse to develop cost-of-service rules that replicate Title II regulation. Like the benchmarks, the Commission's cost of service rules must be specially tailored to the unique circumstances of the cable industry. The cable industry faces far more competition, far greater market risks, greater financial risks from leveraged capital structures, and enjoys far less penetration than traditional utilities. If the

^{31/} Notice at ¶ 5. See also 47 U.S.C. § 543(b)(2)(C)(vii); Rate Regulation (Report and Order and Further Notice of Proposed Rulemaking), 72 R.R.2d 733, at ¶262 (1993) ("Rate Regulation Order") ("[W]e can not [sic] be certain that the initial capped rate defined through benchmark comparisons will permit all cable operators to fully recover the costs of providing basic tier service and continue to attract capital.").

^{32/} See, e.g., Rate Regulation Order at ¶262 (alternative necessary because "an overly tight cap on rates could hinder cable operators [sic] ability to make network improvements that could benefit subscribers"); Notice at ¶ 9 (alternative to benchmarks should "be designed to assure that cable operators may fully respond to incentives to provide a modern communications infrastructure and to respond to competitive forces").

Commission simply develops cost-of-service rules which, as proposed, largely mirror those applied to traditional utilities, it will be contravening the intent of Congress and frustrating the goal of ensuring continued infrastructure improvements by cable operators, while financially devastating the industry.

II. THE COMMISSION SHOULD PERMIT AN OPERATOR TO INCLUDE ALL ACQUISITION COSTS IN ITS RATEBASE

The Commission has tentatively proposed to exclude from a cable operator's ratebase "excess" acquisition costs such as goodwill, customer lists, franchise rights, and other intangible assets.^{33/} Its proposal rests on the assumption that any monies paid to acquire a cable system which exceeded the book value of the seller's plant in service represent an "expectation of monopoly earnings," and thus should be disallowed.^{34/} Adoption of this proposal would gravely disrupt the capital and financial structure of the cable industry, defeat the purpose of the cost of service proceeding, thwart Congressional intent, and run afoul of the Constitution.

A. THE COMMISSION'S EQUATION OF EXCESS ACQUISITION COSTS WITH MONOPOLY RENTS IS ARBITRARY AND CONTRARY TO THE REALITIES OF THE CABLE MARKETPLACE

There is no rational basis for adopting a rule which rests on a blanket assumption that any acquisition costs which exceed

^{33/} Notice at ¶ 40. The Commission's proposal also appears to exclude from ratebase tangible "step-ups." Cable operators often step-up the value of their assets to reflect the difference between the net book value at the time of acquisition and the higher appraised value.

^{34/} Id. at ¶ 36.

the book value of plant in service automatically constitute "an expectation of monopoly earnings."^{35/} The Commission's tentative proposal simply ignores the fact that in the last eight years cable system acquisition prices have been the product of good-faith bargaining between willing buyers and willing sellers in a competitive marketplace.

The Commission's tentative proposal also overlooks the fact that there are a host of valid reasons for a cable system's acquisition price to exceed the book value of its tangible assets.^{36/} The premium paid over book value could reflect any number of legitimate cost factors, each of which inure to the benefit of subscribers. It might reflect the seller's recapture of start-up losses and unrecovered depreciation and interest expenses which were incurred in order to make cable service available to the broadest possible subscriber base in the shortest possible time. So-called "excess" acquisition costs also may reflect the value of intangibles such as subscriber lists, technical expertise, programming discounts, projected growth in penetration levels and advertising revenues -- all of which promote better quality service. In addition, such costs might reflect economies of scale and other efficiencies that lower operating costs, and the deferred investment represented by accumulated net operating losses of the acquired company.

^{35/} Id.

^{36/} The Commission itself seems to be aware of this point. See, e.g., Notice at ¶ 39 n.44.

There are, in short, a myriad of valid explanations for what the Commission has identified as "excess acquisition costs." Accordingly, the Commission is without foundation to prescribe a rule which automatically disallows these costs from inclusion in the ratebase on the assumption that these costs represent monopoly earnings which produce no subscriber benefits.

B. THE BLANKET EXCLUSION OF "EXCESS" ACQUISITION COSTS FROM THE RATEBASE WILL DEFEAT THE PURPOSE OF THE COST OF SERVICE RULES AND THWART CONGRESSIONAL INTENT

The intent of the cost-of-service rules is to encourage continued investment in cable's infrastructure and programming and to ensure the equitable treatment of operators who have a legitimate and economically justified basis for charging rates which exceed the benchmarks.^{37/} As the Commission has acknowledged, cable operators should be able to avail themselves of a cost-of-service proceeding "to avoid . . . harms" that could flow from revenue shortfalls caused by application of the benchmarks.^{38/}

The Commission is certainly correct that its cost of service procedures should enable cable operators to avoid such harms as the impaired access to capital and breach of loan covenants that

^{37/} See Section I, supra.

^{38/} See Rate Regulation (Memorandum Opinion and Order and Further Notice of Proposed Rulemaking), FCC 93-389 (rel. Aug. 10, 1993) ("Stay Order"), at ¶ 13.

would result from diminished cash flow.^{39/} Unfortunately, its tentative proposal to completely disallow so-called "excess acquisition costs" virtually guarantees that these harms will be visited upon some cable operators.

As noted above, Cablevision's systems continue to incur significant operating losses. These systems are not likely to recover the reasonable cost of providing regulated cable service under the benchmarks, which would then exacerbate their operating losses. If cost-of-service rules do not permit the recovery of all costs, including acquisition adjustments, there is no prospect that these systems would achieve positive cash flow in any reasonable period of time.^{40/} Similarly, continued compliance with a number of Cablevision's loan covenants would be greatly jeopardized by the adoption of a blanket rule excluding all excess acquisition costs.^{41/}

^{39/} See id. at ¶ 11 (positing such harms as (1) increased operating losses; (2) diminished cash flow which causes violations of loan covenants which in turn could result in foreclosure by lenders or operator bankruptcy; (3) impaired capacity to obtain future financing; and (4) deprivation of funds needed to implement system upgrades which local authorities require as a condition of franchise retention.

^{40/} Sale of these systems under the tentative regulatory framework proposed by the Commission would be impractical. Cablevision would have to sell the systems for a price which, at a bare minimum, does not fall below the price which it originally paid for them. But since the Commission would already have determined that a substantial portion of that sales price could not be recovered in the ratebase, it is unlikely that many buyers would be attracted to these systems.

^{41/} Thus, operators who borrowed to fund their acquisitions would be hit twice by the Commission's proposal: once, by being deprived of a reasonable return on their investment; and, twice, by potentially failing to meet their loan covenants.

To exclude from Cablevision's ratebase any premium paid over book value would result in serious revenue shortfalls on a number of Cablevision's systems and reduce the income-generating potential of those systems -- before they have even reached maturation. The result would be to aggravate operating losses, destabilize lending and franchise relationships, violate loan covenants, and jeopardize the company's ability to comply with franchise requirements. Under such circumstances, it will be virtually impossible for Cablevision to raise capital for new investment -- just as cable is facing increased competition from direct broadcast satellite services, telephone companies, and others seeking to offer broadband and interactive services -- since all available funds will be needed to preserve the stability of its existing capital base. Clearly, this outcome contravenes both the Commission's goal and Congressional intent.^{42/}

C. EXCLUDING ALL "EXCESS" ACQUISITION COSTS FROM AN OPERATOR'S RATEBASE RAISES SERIOUS CONSTITUTIONAL CONCERNS

The Commission's proposal to exclude all "excess" acquisition costs from an operator's ratebase utterly fails to

^{42/} The Commission has solicited comment on whether Congress intended it disallow excess acquisition costs. Notice at ¶ 37. Congress did give "some credence" to the Professor Tobin's "Q" ratio analysis and took note of the fact that the sales price of cable systems in the 1980s often exceeded the replacement costs of their assets. See Senate Report at 8-11. But nothing in the legislative history suggests that Congress adopted or advocated the position, embodied in the Commission's proposed rule, that any "excess" acquisition costs constitute an irrebuttable presumption of monopoly earnings.